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Economy Watch

THE U.S. economy continues to advance at a brisk pace, with real GNP this quarter rising at an annual rate of about 5½% (table on page 2)—unchanged from last month's estimate.

Slowing in some sectors (notably housing) has muted the especially robust growth pace of the spring and summer. Even so, recent gains in personal income, employment, and factory orders attest to strong forward momentum.

In this environment, lively Christmas spending seems assured. Inventory-to-sales ratios, already quite low in an historical context, may well drift lower. The need for restocking, in turn, could significantly influence the tempo of the economy early in 1984. Even without such a boost, the economy's pace at the turn of the year promises to be brisk enough to make an easing of monetary policy unlikely.

Christmas business surely is drawing strength not only from income gains but also from the upbeat mood of consumers. The confidence index compiled by The Conference Board, for example, reached a five-year high in November. Its rise of some 65% from the year-ago level testifies to the change in national mood since last Christmas.

The strikingly large decline in joblessness undoubtedly has been the key contributing factor. From a high of 10.8% in December of 1982, the jobless rate has continued to tumble—falling, in fact, to a surprisingly low 8.4% last month.*

The sharp decline in the unemployment rate, while surprising against year-ago expectations, is not an unprecedented development in terms

*The rates cited are based on the civilian labor force, i.e., not including in the count members of the armed forces.

of previous experience following other major postwar recessions (those, for example, that troughed in 1958 and 1975).

Behind the drop

The decline in unemployment has been roughly of the same size, measured in percentage points, as that which occurred after the 1958 business-cycle trough (shown in table below). The decline has been considerably larger, however, than that which occurred after the 1975 trough. The gain in employment has been approximately the same this time as it was then, but the labor force has grown much more slowly. Not only was the population of working age rising at a comparatively fast pace after the 1975 trough (owing to the high birth rates of the late-1950s), but participation rates also increased, due to the entry of growing numbers of women into the work force.

Now, in contrast, change in the size of the working-age population is being held back by the much reduced birth rates of the mid-1960s. And labor-force participation has declined, constraining further the growth of the labor force. The latter development doesn't seem to be related to current business conditions, nor does it seem to reflect unusual discouragement on the part of workers seeking jobs. The labor-force participation rate of men, significantly, is rising as the economy recovers. That of women seems to be stabilizing after the dramatic increases of the 1970s and early 1980s.

Unemployment in Three Recoveries

(Percent change during first year of recovery)

	Trough Month		
	April 1958	*March 1975*	*Nov. 1982*
Unemployment rate*	−2.2	−1.0	−2.3
Employment	3.2	3.2	3.5
Labor force**	1.0	2.2	0.9
Population of working age	1.4	2.0	1.1
Participation rate	−0.3	0.2	−0.3

*Change measured in percentage points.
**Based on the civilian labor force, i.e., excluding members of the armed forces.

Economic Projections

(Percent change at annual rate from previous quarter, except where noted)

	1983	*1984*			
	Q4	*Q1*	*Q2*	*Q3*	*Q4*
Real GNP	5.5	4.6	4.5	4.6	4.6
Real consumer spending	4.0	4.5	3.4	3.3	2.9
Real business-capital outlays	12.3	9.9	9.2	8.6	9.9
GNP deflator	4.5	4.6	4.3	4.4	4.8
Consumer prices	4.9	4.9	4.7	4.6	4.5
Real disposable personal income	6.0	2.4	2.8	3.2	3.5
Saving rate (%)	5.3	4.8	4.7	4.6	4.8
Housing starts (Millions)	1.7	1.7	1.7	1.7	1.7
Auto sales (Millions)	9.6	9.9	10.1	10.3	10.4
Unemployment rate (%)	8.5	8.3	8.1	7.9	7.8

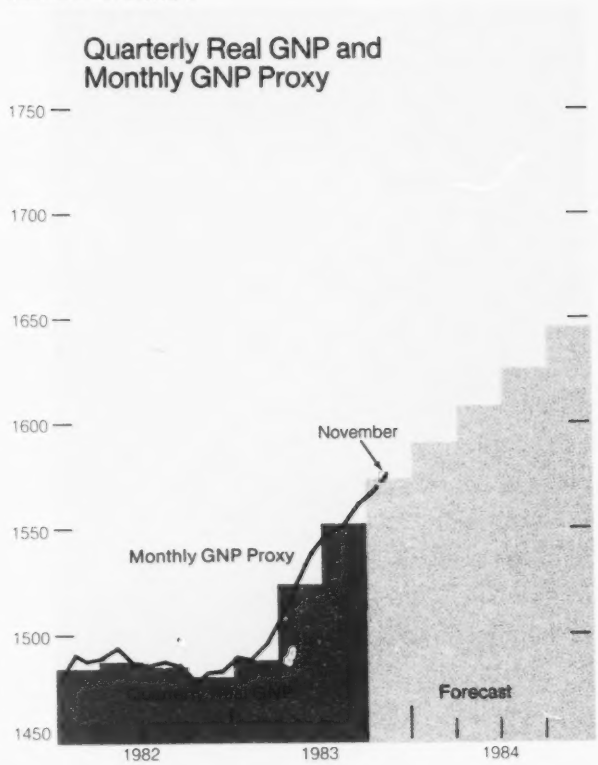
Further reductions ahead

In the coming year, a further reduction in joblessness will be harder to come by. The economy's rate of advance will be slowing—as it already seems to be—consistent with the pattern in the second year of past cyclical upswings. And that will tend to moderate the

growth of employment. Even so, a further significant reduction in joblessness, contrary to the experience in other expansions in the second year, seems to lie ahead. Again, the main reason will be the slowing in the growth of the working-age population. Unless something unforeseen happens to labor-force participation rates, November 1984 is apt to see a jobless rate just under 8%—some three percentage points below where it was only a year ago.

Such an outcome, even as recently as a month or two ago, seemed highly optimistic. The tendency was to discount the weakness in the increase of the labor force as it was reported month by month. Now, however—especially with the sharp drop in joblessness not only in November but in October as well (almost a full percentage point in the two months combined)—less skepticism about the genuineness of the decline is warranted. So, also, is more optimism warranted about what the labor markets will be reporting a year from now.

Billions of 1972 dollars



Note: Proxy is derived by interpolation from quarterly GNP (actual and projected) on the basis of available monthly data.

The Changing Mix of Business Financing

SHORT-TERM business credit* rose at an estimated 10.6% annual clip between July and October, after rising at a seasonally adjusted annual rate of only 1.3% in the first seven months of the year.

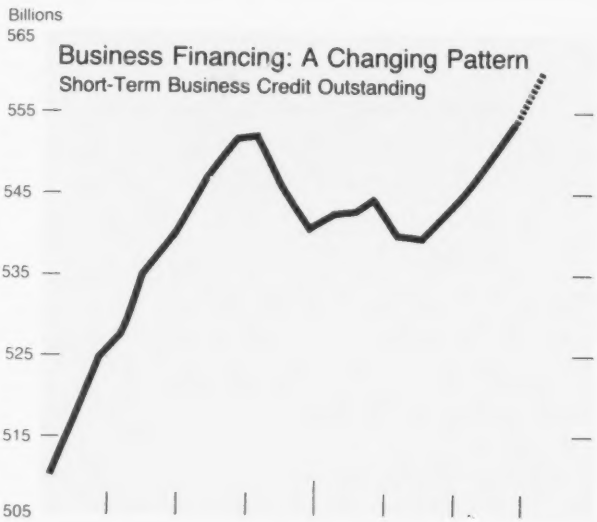
A surge in business loans by finance companies is a major reason. But even excluding that lending, short-term credit grew at a brisk 7.5%.

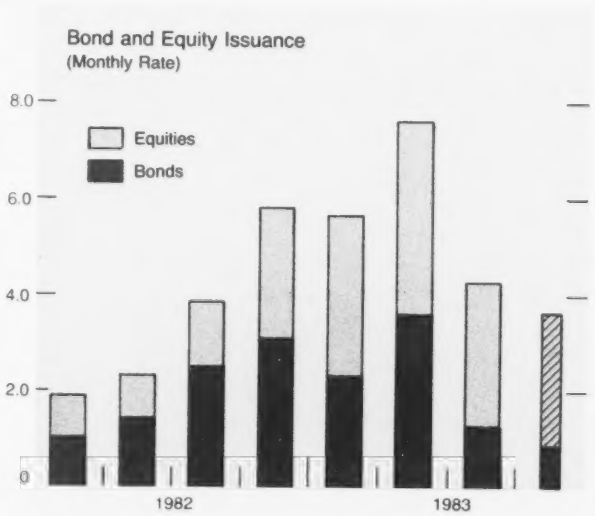
Does the sudden rise signal upward pressure on interest rates as private borrowing begins to clash with federal-credit needs? The answer appears to be: no—not yet, anyway.

A broader look at overall business financing patterns suggests that the recent pickup in short-term business-credit demands represents more a change in the composition of fund raising than an increase in the overall amount of business external financing.

While short-term business credit accelerated in the July-October period, gross issuance of long-term debt and equity by nonfinancial corporations in that period dropped to two-thirds of the rate in the first seven months (accompanying chart). For example, nonfinancial corporate bond offerings averaged $1.1 billion at a monthly rate in the three months ended in October, as compared with $2.7 billion in the January-July period. In the same span, equity issuance (including preferred stock) fell back to a $2.8 billion monthly rate from the record rate of $3.7 billion in the first seven months.

That shift in composition results, in part, from the reversal by early summer of the declines in bond rates and of the increases in share prices that had facilitated the issuance of large volumes of lower-cost debt and equity in the spring. Following the Fed's tightening in late May, and the simultaneous emergence of a stalemate over policies to reduce large prospective federal budget deficits, long-term interest rates rose by more than short-term rates. For example, double A rated corporate bond yields jumped 150 basis points by August, while one month bank





Note: Data for business credit extended by finance companies are actual through September, and estimated by The Morgan Bank for October. The plotting for bond and equity issues for the fourth quarter of 1983 is based on data for October.

*Commercial and industrial loans at all banks, loans to U.S. companies that are booked at offshore branches of U.S. banks, commercial paper issued by nonfinancial corporations, and business credit extended by finance companies.

CMOs AND MORTGAGE FINANCE

THE latest wrinkle in mortgage finance is the collateralized mortgage obligation (CMO). Introduced in June by the Federal Home Loan Mortgage Corporation, this financing vehicle has already been used to raise almost $5 billion, and more offerings are on the way.

CMOs are a new breed of mortgage-backed security. They are backed either by a specific pool of mortgages or by other mortgage-backed securities. The interest and principal of the collateral (less service and guaranty fees) are passed through by the issuer to the holder of the CMOs. Unlike other mortgage-backed securities, however, CMOs offer investors a choice of securities with different payout schedules and guaranteed minimum yields. Prepayments of principal in the underlying mortgage pool are applied to one class at a time until that class is retired.

The "slow-pay" CMOs have been especially appealing to investors interested primarily in longer-term assets. Pension funds, for example, now have greater assurance that the mortgage-backed securities they buy won't be retired too soon. This increases their ability to match asset maturities against those of their liabilities and thus reduces their exposure to changes in interest rates. On the other hand, "fast-pay," or shorter-term, CMOs have been popular with thrift institutions. They can use these new instruments more effectively than the traditional mortgage-backed securities to match the maturities of their mortgage investments with their shorter-lived deposit liabilities.

What of the future? Growth in CMOs clearly would benefit from creation of so-called Trusts for Investments in Mortgages (TIMs), but enabling legislation faces Congressional hurdles.* Nevertheless, the 25 or so offerings of CMOs now in the pipeline attest to their popularity and to their potential for widening the channel through which credit flows from capital markets to mortgage markets.

*TIMs would permit CMO issuers to remove these securities—and the assets behind them—from their balance sheets. This would enable issuers to earn a stable flow of fee income, independent of interest rate fluctuations and without reducing capital ratios, just as they now do with the standard garden-variety mortgage-backed security.

CD rates rose only three-quarters of a point. Those treasurers who got squeezed by the rise in rates had little choice but to roll over short-term liabilities.

A second reason for change in the credit composition was the replenishing of inventories in the third quarter. That was initiated by companies once it became clear that the recovery was not going to fizzle out. Although the connection between the maturity of financing instruments and the maturity of financing needs has loosened in recent years, this development seems likely to have prompted the issuance of more short-term debt. Whereas earlier in the year investment outlays were financed by a combination of strong cash flows and long-term debt and equity issuance, inventory rebuilding has probably given rise to increased dependence on shorter-term debt (such as commercial paper and loans from banks and finance firms).

Considered broadly, corporate external financing is showing the moderate rise that has been expected. Clearly, however, there has been a shift toward the use of short-term credit, which has pretty well halted the restructuring of corporate balance sheets. Ordinarily, heavier dependence on short-term funds might put profits in jeopardy, if interest rates should rise steeply. Happily, that prospect seems unlikely anytime soon.

Inflation Barometer: Rougher Weather Ahead

Economists' forecasts on inflation generally see a moderate rise ahead for 1984—in the 5%-to-6% range for the consumer price index, as against less than a 4% rise this year.

What follows is a somewhat more pessimistic view. It was written by Geoffrey H. Moore, Director, Center for International Business Cycle Research, Columbia University, and by Professor Stanley Kaish of Rutgers University.

IN a recent issue of the *Survey*,* we reported development of a new leading index of inflation. Between 1948 and 1980 the index had successfully anticipated each of the eight cyclical peaks in the inflation rate by an average of ten months and each of the eight troughs by an average of seven months.

The index is a composite of three series that reflects pressure in the commodity, financial, and labor markets. All three series have risen from their cyclical lows. Now that the upswing in the leading index has proceeded long enough and far enough to make one reasonably confident that it is cyclical and not just a blip, we can consider what it implies for the inflation rate.

Since the leading index has risen from its December 1982 low of 98.4 to a November 1983 reading of 112.6, or roughly 14 points, we may surmise that if past relationships are maintained, the inflation rate will rise about five percentage points from its trough level of about 2% in March 1983. Hence the increase in the leading index to date is pointing to an inflation rate of around 7%. By October it had already risen to 4%.

In one sense the 7% is a conservative estimate, since it assumes the leading index will rise no further. It seems likely that the index will indeed move higher before peaking. Expansions of the leading index since 1948 lasted 26 months on average, with only one less than a year. By November we were 11 months into the current expansion. We most likely have a way to go. If the leading index rises further, it will imply a higher level of inflation than 7% before it peaks.

A 9% peak?

In this regard, several important points are worth noting. 1) The leading index has risen more rapidly during the 11 months since its December trough than during the first 11 months of any of its previous expansions. 2) The leading index shows no regular pattern over the various cycles with regard to its rate of growth. During some it grew rapidly in the beginning; during others it grew faster at the end. 3) There is no demonstrated month-to-month correlation between the leading index and inflation—only a cycle-to-cycle correlation. These points suggest that the pressures indicated by the index will eventually manifest themselves before the expansion is over. However, they do not say that because the early months of the cycle saw big moves in the leading index, the early months of the inflation cycle will similarly see big moves in inflation. Nor do they say that the eventual rise in the inflation rate can be forecast from the first 11 months' rise in the index. Strictly speaking, what the past relationship tells us is that if the expansion in the leading index ended tomorrow, inflation would be likely to rise to the neighborhood of 7% before turning down. If the leading index were to

*"A New Inflation Barometer," *The Morgan Guaranty Survey*, July 1983.

Cyclical Changes in the Leading Inflation Index and the Inflation Rate (CPI), 1949-83

Dates of Peaks and Troughs				*Changes during Expansions*		
Leading Inflation Index		*Inflation Rate*		*Leading Index*	*Inflation Rate*	
Trough	*Peak*	*Trough*	*Peak*		*Actual*	*Estimated*
6/49	11/50	7/49	2/51	+34	+16	+14
8/52	3/53	3/53	10/53	+ 7	+ 2	+ 3
7/54	12/55	10/54	8/57	+14	+ 5	+ 6
4/58	7/59	3/59	10/59	+14	+ 2	+ 6
2/61	1/66	6/61	10/66	+ 8	+ 3	+ 3
4/67	4/69	5/67	2/70	+11	+ 4	+ 4
11/70	3/73	6/72	9/74	+24	+10	+10
6/75	3/79	6/76	3/80	+28	+10	+11
12/82		3/83				

NOTE: Changes in the leading index are measured in index points (1967=100) between its peak and trough dates. Changes in the rate of inflation (CPI) are measured in percentage points between its peak and trough dates. The inflation rate is the six-month smoothed rate, based upon the ratio of the current month's seasonally adjusted index to the average index during the preceding twelve months, expressed at annual rate. The "estimated" change in the inflation rate is 40% of the change in the leading index, based on the average relationship during both expansions and contractions.

achieve the *average* cyclical rise of 18 points seen during the eight expansions on record, the relationship tells us that inflation would rise about seven points to a peak level around 9% annually.

There is an additional sign that the worst days of inflation are not likely to be revisited soon. One of the characteristics of the worsening inflation picture that ran from the mid 1960s to 1980 was a pattern of rising peaks and troughs. Each time inflation bottomed out it did so at a level higher than the previous trough, and then it rose to a higher peak than previously. In 1982-83 the pattern was broken. Inflation dropped below the 1976 trough of 4.9% and fell to 1.8%. In order for inflation to resume its ascending peak format, the leading index would have to rise more than 30 points from its recent low of 98.4 during the current expansion. Such a rise occurred only once in our chronology and that was during the Korean War. Furthermore, such a rise would put the index at a level in excess of 128, a height never reached before. Assuming that peace prevails, the outlook is for more inflation, but not as much more as we unfortunately came to expect during 1965-1980.

Oil Imports: A Temporary Upswing

IMPORTS of crude oil and refined petroleum products surged from a rate of 3½ million barrels per day (bpd) in the first quarter to 5½ million bpd in the third quarter. And every indication is that oil imports have continued to run at a comparatively high rate during the closing months of the year. But the rise does not appear to signal an end to the heartening downtrend of the late 1970s and early 1980s (chart on this page). Instead, it seems to be the result of forces that are not apt to recur.

Most important, changes in oil inventories have had a sizable effect. Stocks fell by 600,000 bpd during the first quarter—presumably as refiners and others hedged against the possibility of a major softening in international oil prices. As prices stabilized in the spring, however, the incentive for such hedging was greatly reduced. Inventories began to be rebuilt, with acquisition rates rising to 900,000 bpd during the third quarter. The 1½ million-bpd swing in stocks alone accounts for three-quarters of the rise in the rate of imports between the first and third quarters.

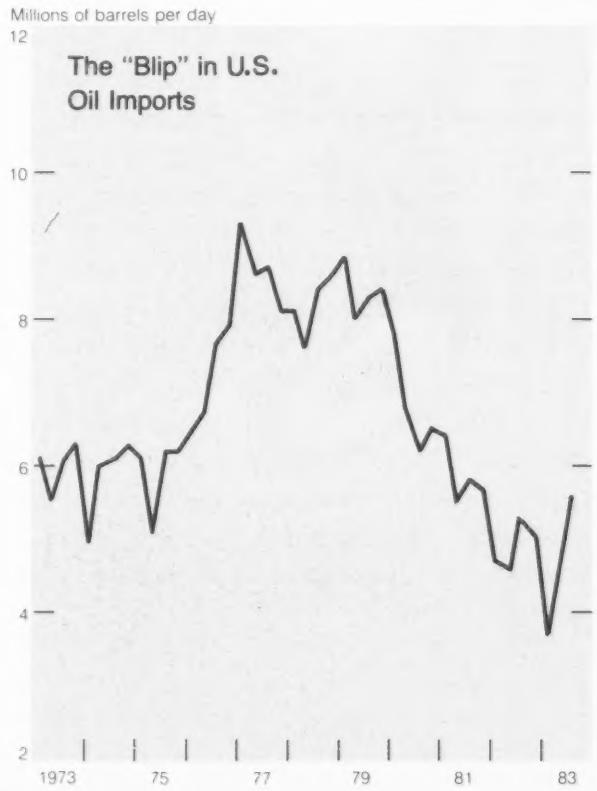
Next year, inventories are unlikely to rise significantly. The recent rebuilding has brought U.S. stocks up to near their all-time high relative to consumption. On that basis, privately held stocks (that is, not counting oil held by the federal government in the strategic Petroleum Reserve) are now about 10% higher* than they were on average in the previous 10 years. Lessened inventory building during 1984 should not only keep imports from rising further but should actually reduce them from current levels.

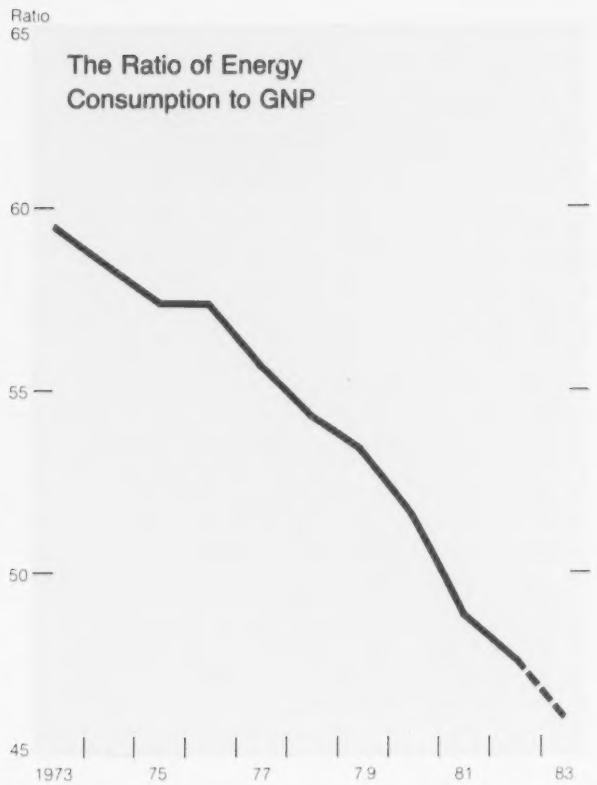
*The U.S. stands out among the countries of the International Energy Agency (IEA) in meeting the agency's goal of boosting oil inventories as a defense against supply disruptions. Including oil held in the Strategic Petroleum Reserve, stocks in the U.S. in the first seven months of this year averaged 112% of their average level during the previous 10 years. The comparable figures for the next six largest IEA members—the U.K., Germany, France, Italy, Japan, and Canada—ranged from 76% to 107%, and averaged only 90%.

Continuing the downtrend

The rapid growth in economic activity in the past year has increased demand for energy. But this source of lift for oil imports also should ease in the year ahead, in line with the moderating pace of the recovery in its second year (Economy Watch, page 1). Total energy consumption per unit of output in the U.S., which has trended downward since the mid-1970s, seems likely to continue to slip (chart at the top of page 9).

The impact of recovery has been magnified in





Note: Consumption is measured in quadrillion BTU's and GNP is measured in constant 1972 dollars.

oil markets because of the shift from natural gas to oil by industrial firms and electric utilities—a shift that may well be reversed in the year ahead. At present, the demand for oil by these fuel users—many of whom can readily adapt to either fuel—is rising from year-ago levels while their consumption of gas continues to fall. Oil usage by industry rose 1% in the three months through August, the latest available readings; usage by utilities is up 14%. Meanwhile, gas usage declined 6% in industry and 10% at utilities.

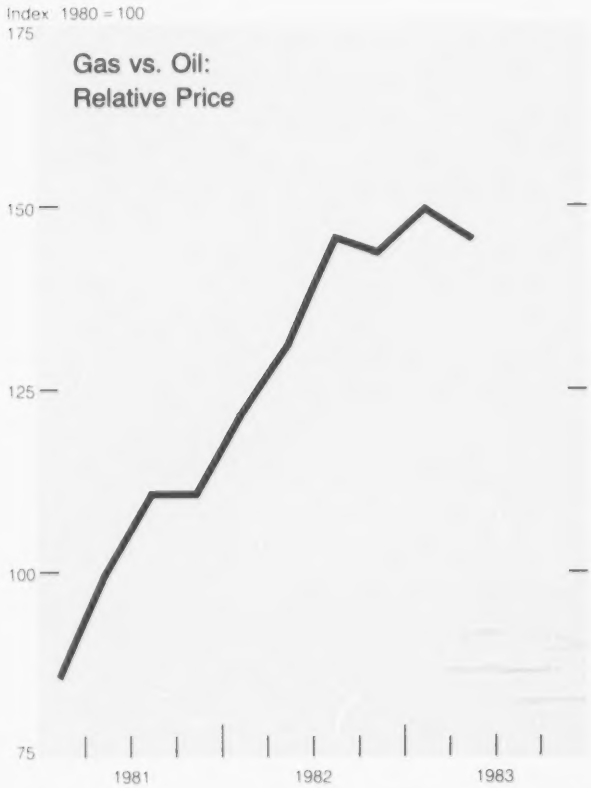
For several years, in fact, gas has lost out in both markets, reflecting in large part responses to changing relative prices.* The relative price of gas (on a comparable BTU basis) delivered to electric utilities, for example, has risen roughly 50% since 1980 (chart below).

This not only has encouraged fuel switching, but it also has caused excess capacity in the gas industry, which is now producing only about 80% of what it had been producing in the late 1970s and the early 1980s. Overcapacity, however, seems to have cut short the rise in relative gas prices, blunting the incentive of price-sensitive users to switch to oil.*

The change in natural-gas markets is likely to reduce oil imports. If, for example, only half

*This year oil is supplying an estimated 49% of the combined oil and gas needs of industry and utilities, as compared with 47% in 1981.

*Mindful of the competitive pressures, marketers of gas have been careful to hold down prices to utilities and industry. But gas prices to residential customers—who lack the ability to switch fuels easily—have continued to rise sharply.



Note: The relative price is based on the cost per BTU of natural gas delivered to electric utilities as against the cost per BTU of residual oil.

of the gas industry's overcapacity were to be absorbed, the associated increase in the consumption of gas—about 2 trillion cubic feet annually—would translate into a decline in oil imports of roughly 1 million bpd. (This assumes that production of oil in the U.S. continues to remain essentially stable.)

Considerable absorption of the industry's excess capacity would be reasonable to expect, given the efforts now being made by gas marketers to price competitively, at least to keep relative prices from rising further. Pipeline companies, for example, are pressing to renegotiate long-term contracts with producers, and in many cases they are succeeding. Added downward pressure on gas prices is coming from growing "off-system" and spot sales to utilities and industrial firms. In many cases, in fact, pipeline companies are offering gas to wholesale consumers at prices significantly below prices for residual fuel oil in order to regain market share. Even at the wellhead, constraints on pricing are evident: Prices have stabilized in the past six months after several years of increases at a rate of about 25% per year.

Staying in line

All in all, the recent surge in oil imports cannot be expected to last. Rather, imports of oil in 1984 should ease from their recent pace, quite possibly averaging between 4½ million and 5 million bpd—very much in line with the downtrend that began in the late 1970s.

The Tug-of-War Over "Float"

THE dollar value of all outstanding checks at any given time is now nearly $380 billion. At current interest rates, this "float," as it is called, is worth $36 billion a year. Small wonder, then, that hundreds of millions of dollars will be spent this year in a financial tug-of-war for these funds. Because the level of float—the amount of outstanding checks—is determined by how fast checks are presented to disbursing banks for funds, disbursers work to slow check collections in order to retain the use of the funds for as long as possible. At the same time, check collectors try to expedite the collections to obtain funds sooner.

The resources poured into the battle are only part of the cost to society. Check float hinders the development of electronic methods of payment that would increase the efficiency of the payments system. As long as disbursers can obtain float worth billions when they pay by check, they have little incentive to switch to electronic payments.

Check float can be divided into four major categories that correspond to the location of the check in the payments process: in the mail, held by the recipient, handled by the bank, and processed by the Federal Reserve.* For mail and recipient float, the time period of float is simply the time the check is in the mail or held by the recipient. For bank float, the interval is the time from receipt of the check by the bank to the time it obtains "good funds." For Fed float, the period is the interval between when the Fed passes credit to the collecting bank and when the Fed actually collects the check.

*The Fed processes checks through the 12 regional Federal Reserve Banks. A check need not generate each type of check float: many checks are not mailed or cleared through the Fed.

The value of check float is simply the product of the quantity of check float outstanding and the interest rate at which these funds could be invested (accompanying table).

Fighting for float

Businesses, individuals, and other parties that are paid by check engage in a continual struggle with their payors over mail and bank float. Collectors try to reduce mail float by locating collection points close to where the checks are mailed, and disbursers counter this tactic by mailing the checks from remote locations. To cut the level of bank float, collecting banks hire air and ground courier services to move checks through the night to meet Fed, local clearinghouse, or bank deadlines for same-day credit.

Measuring Check Float

	Billions of dollars	
	*Level**	*Value*** *(per year)*
Federal Reserve	1.3	0.12
Bank	58.0	5.51
Mail	123.3	11.71
Recipient	197.3	18.74
Total check float	**379.9**	**36.08**

*Estimates for levels of mail and recipient float are much less precise than are those for bank and Federal Reserve float. Mail and recipient float calculations start from an estimate of the dollar value of checks issued in 1983. For mail float, half of all checks are assumed to be mailed and the average mail time is assumed to equal 2.5 days. The level of mail float is then calculated: Mail float = .5 × 2.5 days/365 days × $36 trillion. For recipient float, recipients are assumed to hold checks an average of 2 days. The level can then be calculated: Recipient float = 2 days/365 days × $36 trillion.

**Calculated using a short-term interest rate of 9½%.

Disbursers make this task more difficult by locating their accounts in locations that collectors cannot easily reach—a practice known as remote disbursement.*

Unlike mail and bank float, the level of recipient float is generally determined by recipients alone because it is difficult for disbursers to influence how long recipients hold their checks. Recipients try to reduce its level by establishing lockbox operations with commercial banks. Checks delivered to a post office box are picked up by commercial banks (often in the middle of the night) to be collected as quickly as possible.

The fourth category—Fed float—is of lesser concern to collectors and disbursers. For collectors, an increase in Fed float is no longer a windfall because the collecting bank must now pay for the value of these funds (box on page 13). For the disburser, as always, the concern is when the check funds will be surrendered. The timing of when the Fed passes credit to the collecting bank is not important if the disburser need not lose use of the funds at that time.

Operational improvements have reduced Fed float to a fraction of its earlier average level—to slightly more than $1 billion today from $7 billion in 1979. Some analysts have argued that such a drop, coupled with the charges the Fed now imposes for float, will have a profound effect on the nation's payments mechanism. They claim that the end of this subsidy to check use will significantly reduce the desire to use checks.

Clearly, the end of free float lessens the incentive by removing a subsidy to check use that reached a peak of about $1.1 billion at an annual rate in December 1980. But the value of Fed float has always been dwarfed by the total value of check float. At its peak in 1979, Fed float was only about three percent of total check float. Currently, Fed float is even a smaller proportion of total check float.

The game will likely continue to be played as before. The key determinant of how hard it is played is apt to be the level of interest rates. While the end of free Fed float reduces the value of float, at current levels, by about $120 million, the dramatic fall in interest rates since 1981 has had a far greater effect. The value of check float has fallen to $36 billion—half its peak level in 1981.

Although the value of the funds gained by winners just offsets the value of the funds lost by the losers, the game, over all, is a losing proposition because collectors and disbursers spend a lot of money to play. They incur these expenditures to improve their prospects of becoming winners in the game.

On balance, the winners are those collectors and disbursers with a sufficiently large dollar volume of checks to justify the expenditures necessary to speed or slow collection. Generally, the losers are those with small volumes of checks for whom increased efforts to expedite or impede collection are not cost-effective. For example, consumers and small businesses in, say, Nashua, New Hampshire, generally have few options to accelerate the collection of a check drawn on Grand Junction, Colorado, nor can they reasonably refuse to make payment to the lockbox location in their region even when the business headquarters is located across the country.

Impediment to electronic payments

One of the most insidious effects of check float is that it restrains the rapid development

*Some businesses disburse checks to customers located on the East Coast from West Coast banks and to West Coast customers from East Coast banks.

SINKING FED FLOAT

THE Monetary Control Act of 1980 mandated that the Fed charge fees to recover the cost of providing check clearing and other services. In addition, the Fed was directed to charge for Federal Reserve float at the Federal funds rate.*

Faced with these directives, the Fed realized that if it incorporated the charges for float in its fee structure right away, the cost of its check clearing service would not be competitive with the large commercial banks that also offered check clearing services. In 1981, charges for float would have more than doubled the cost of using the Fed's check clearing system.

Faced with this prospect, the Fed delayed charging for float until after it was able to implement a strategy to mitigate the effect float charges would have on its competitive position. The Fed strategy had three parts:

- Operational improvements to reduce the level of Fed float.
- Regulatory changes to allow presentment to banks closed in mid-week and to delay credit to collecting banks on checks drawn on certain hard-to-reach locations.
- Improvements in the quality of service through later deposit deadlines for same-day or next-day credit. (This change was accomplished by reconfiguring the check transportation system and moving check presentment times to later in the day.)

By June of this year, the Fed had reduced check float to $1.7 billion from a level of $7.4 billion in the first half of 1979. Meanwhile, the new deposit deadlines implemented early this year allowed the Fed to accelerate by one day the collection of $2 billion worth of checks daily. Thus, when the Fed started to charge for float in July, it had already made service improvements with greater value than the float charges it was imposing.

*Discussed in "Fees for Fed Float," *The Morgan Guaranty Survey*, August 1980.

of electronic methods of payment. Even when electronic payments could be executed at a lower cost, they are not always utilized because they typically do not generate any float benefits for the disburser of funds.

For disbursers, the cost of making payment by check has risen rapidly in the past few years —driven upward by the imposition of Fed check-clearing fees and the explicit, "unbundled" pricing of check services by banks. Meanwhile, technological innovation has continued to reduce the cost of electronic payments. In many applications electronic payments have become less expensive to execute than check payments. Despite this cost advantage, disbursers have been slow to embrace electronic payments because the value of the check float that is forgone when an electronic payment is made typically exceeds this operational cost savings.

A recent study that compared the cost of government check payments and electronic direct deposit payments makes this point clear. Ignoring float, the cost of check payments to the Federal government was estimated to be about 40 cents per item and the cost of direct deposit payments about 27 cents per item in 1981, a substantial savings of 13 cents per item or 33%. However, when the cost of forgone check float was added to other direct deposit costs, the cost of direct deposit payments increased to 97 cents per item, far greater than the cost of check payments.

What can be done?

Clearly, check float has a pernicious effect on

the efficiency of the payments process—fostering a significant waste of resources in the check collection business. If collectors and disbursers of payments could agree on a schedule of payment after receipt of the check—in effect an industry standard for check collection—the incentives to accelerate or impede collections would be substantially reduced. The industry standard could be set in terms of the number of days from receipt of a check before credit would be given (for example, five business days until credit could be received), or the disburser of the check could be required to pay the collector for any float that was generated. In the first case, collection could be made by the least-cost method of transportation that ensured collection that satisfied the industry standard. In the second case, the funds would tend to be collected by the most efficient methods commensurate with the value (in terms of increased liquidity or reduced risk) of obtaining the funds more quickly. In both cases, the costs expended to collect and issue checks would be significantly reduced.

The problem in reaching such a solution lies in the multilateral nature of the payments process. Negotiation between all possible pairs of collectors and disbursers to reach such a standdard is unlikely. The gain for any pair of bargainers would tend to be small relative to the costs of reaching an agreement. To date, negotiated agreements between collectors and disbursers that establish guidelines governing the transfer of funds have been the exception rather than the rule.

Needed: a collective effort

What is needed is a collective effort to establish standards that determine the timing when funds are transferred. If the float benefit of check use were eliminated in this manner, the major impediment to the widespread use of electronic payment transactions would be removed. Electronic payments offer significant advantages over check payments in terms of cost of execution, reliability, and certainty when the transfer of funds will actually occur. Although development of an acceptable standard might prove difficult, the benefits that are attainable make such an effort worthwhile.

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